The Supreme Court of the United States on the "absolute" priority rule in structured dismissals – A structural dam to stem a flood of undesirable consequences

A post by guest blogger Frederik De Leo

On 22 March 2017, the Supreme Court of the United States expressed its opinion (in the context of a Chapter 11 procedure) on the following question:

"Can a bankruptcy court approve a structured dismissal that provides for distributions that do not follow ordinary priority rules without the affected creditors' consent?"

Under the slogan: "Why step over a dollar to pick up a dime?", the Court answers this complicated question with a simple "no", thereby overruling the Bankruptcy Court, District Court and Third Circuit in an orderly fashion.

"We begin with a few fundamentals"

After distilling the above point of law from the complex facts (*infra*), the Supreme Court starts with a few fundamentals which are essential for a Belgian lawyer to gain a full understanding of the opinion of the Court.

A Chapter 11 procedure (cf. *gerechtelijke reorganisatie door collectief akkoord*) has three potential outcomes: (1) the reorganization plan is approved and confirmed, (2) the Chapter 11 procedure is converted into a Chapter 7 procedure (cf. *faillissementsprocedure*) and (3) a Chapter 11 procedure is dismissed (*verwerping*). In principle, a dismissal aims to return the parties to the prepetition financial *status quo* (11 U.S.C. § 349(b)(3)). Achieving this, however, is easier said than done. That is why §349(b) permits the bankruptcy court, "for cause", to alter a Chapter 11 dismissal's ordinary restorative consequences, so that it becomes a structured dismissal. The American Bankruptcy Institute describes a structured dismissal as follows:

"hybrid dismissal and confirmation order… that… typically dismisses the case while, among other things, approving certain distributions to creditors, granting certain third-party releases, enjoining certain conduct by creditors, and not necessarily vacating orders or unwinding transactions undertaken during the case"

*(*American Bankruptcy Institute Commission To Study the Reform of Chapter 11, 2012-2014, Final Report and Recommendations, 2014, 270*)*.

This raises questions as to the potential conflict between a structured dismissal and the absolute priority rule. The absolute priority rule can be defined as a rule on the basis of which *"a dissenting class of creditors must be satisfied in full before a more junior class may receive any distribution or keep any interest under the restructuring plan" (*Art. 2(10) of the proposal for a directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU, Strasbourg, 22 November 2016, COM (2016) 723*)*.

The facts of the case

In 2006, Sun Capital Partners, a private equity firm, acquired Jevic Transportation Corporation with money borrowed from CIT Group in a leveraged buyout. Two years after Sun's buyout, Jevic Transporation Corporation filed for Chapter 11 bankruptcy. At the time of filing, Jevic owed $53 million to senior secured creditors Sun and CIT, and over $20 million to tax and general unsecured creditors. Those circumstances led to two lawsuits. In the first lawsuit, a group of former truck drivers of Jevic sued Jevic and Sun. The claim against Jevic resulted in a judgement in favor of the truck drivers, worth $12,4 million, $8,3 million of which represented a priority wage claim under 11 U.S.C. §507(a)(4). In the second lawsuit, a committee representing Jevic's unsecured creditors sued Sun and CIT.

In this second lawsuit, Sun, CIT, Jevic and the committee representing Jevic's unsecured creditors reached a settlement agreement. Sun insisted that the petitioners of the first lawsuit, *i.e.* a group of former truck drivers of Jevic, would not receive anything. If they did, Sun would finance the lawsuit from the group of former truck drivers of Jevic against Sun *itself*. Consequently, the settlement required a structured dismissal which provided for a distribution deviating from the absolute priority rule. Sun, CIT, Jevic and the committee asked the Bankruptcy Court to approve the settlement and dismiss the Chapter 11 bankruptcy case (structured dismissal). The former truck drivers as well as the US Trustee objected because the settlement plan distributed estate money to low-priority general unsecured creditors while the truck drivers – who, by virtue of their judgement, had mid-level priority claims against estate assets – had not been fully paid yet. That would be in conflict with the absolute priority rule.

The Bankruptcy Court ruled that a violation of the absolute priority rule did not necessarily bar approval of a settlement plan because the proposed payouts would occur pursuant to a structured dismissal of a Chapter 11 petition rather than an approval of a Chapter 11 plan. According to the Court, there was no realistic prospect that, without the settlement and structured dismissal, there would be a meaningful distribution for anyone other than the secured creditors. The District Court and Third Circuit affirmed the Bankruptcy Court's decision (*In re Jevic Holding Corp*., 2014 WL 268613).

The absolute priority rule

To answer the above-cited point of law, the Court started by recalling that the absolute priority rule has long been considered as fundamental to the Bankruptcy Code's operation. The distribution of the estate assets in a bankruptcy procedure should be in conformity with the predetermined statutory and contractual priorities (M.J. ROE en F. TUNG, "Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain", *Virginia Law Review* 2013, (1235) 1243).

Subsequently, the Court refers to the fact that the legislator remains completely silent about derogations from the absolute priority rule in structured dismissals (see 11 U.S.C. §1112(b): Neither the word "dismiss", nor "structured", nor "conditions" indicates the possibility to derogate from the absolute priority rule). It is indeed *un*likely that the legislator would have tacitly provided a backdoor to achieve the exact kind of priority-violating distributions that bankruptcy law prohibits in Chapter 7 liquidations and Chapter 11 plans. In contrast, the bulk of the provisions concerning dismissals in Chapter 11 bankruptcies foresee in transfers of assets to restore the prepetition financial *status quo* (11 U.S.C. §349(b)). The only phrase in §349(b) which deviates slightly from this, states that a bankruptcy judge may, "for cause, orde[r] otherwise" (*i.e.* structured dismissal). However, a contextual and teleological interpretation of that phrase leads the Court to the conclusion that this provision is designed to create the required flexibility for the judiciary to safeguard the rights which the parties would have acquired by relying on the pending Chapter 11 procedure.

Contrary precedents? Non-existing

Next, the Court starts looking for contrary precedents. Unsurprisingly – since the practice of structured dismissals is relatively new –, the Court finds none. The Third Circuit referred briefly to *In re Buffet Partners* (L.P., 2014 WL 3735804). Indeed, the Court approved a structured dismissal in that case, but the facts differed substantially in one key respect: none of the parties with an economic stake in the case had objected to the structured dismissal. The other case on which the Third Circuit relied, was *In re Iridium Operating LLC* (478 F. 3d 452). However, that case did not involve a structured dismissal, which is a *final* distribution of the estate value, but an *interim* distribution of settlement proceeds to fund a litigation trust that would press claims on the estate's behalf. The Court recognizes that *In re Iridium Operating LLC* is not an isolated case, but that courts regularly approve *interim* distributions that violate ordinary priority rules. Be that as it may, those distributions concern payouts to players who are vital for the going concern of the enterprise, such as employees, key suppliers and providers of fresh money (e.g. distressed debt investors). Those distributions, although in principle in breach of the absolute priority rule, are necessary so that a reorganization can take place successfully and the value of the estate can be maximized. Thanks to that "detrimental" distribution, the *prima facie* disadvantaged creditors will eventually be better off than without that distribution (e.g. *In re Kmarkt Corp.*, 359 F. 3d 866, 872; *Toibb v. Radloff*, 501 U.S. 157, 163-164). Consequently, one can assume that the creditors would have agreed to this course of action *ex-ante* (*hypothetical creditors' bargain*).

The facts about which the Court had to decide in this case are therefore not the same as those of previous cases. In a structured dismissal, like in the present case, a distribution in violation of the absolute priority rule is a *definitive* distribution and *not* an interim distribution. A priority-violating distribution in a structured dismissal, as in the case at hand, does *not* help the business-debtor to continue to exist; it does *not* make the disadvantaged creditors better off; it does *not* increase the chances of an approval of the reorganization plan; it does *not* help to restore the *status quo ante* of the creditors; and it does *not* protect any reliance interests. On the contrary. The distribution in the present case closely resembles proposed transactions that lower courts in the past have refused to allow, precisely because those transactions tried to circumvent the procedural safeguards provided for by bankruptcy law (See e.g. *In re Braniff Airways, Inc.*, 700 F. 2d 935, 940; *In re Lionel Corp.*, 722 F. 2d 1063, 1069; *In re Biolitec, Inc.*, 528 B. R. 261, 269; *In re Chrysler LLC*, 576 F. 3d 108, 118).

The risk of a flood of undesirable consequences

Consequently, the Court has – in our opinion correctly – ruled out the "rare case" exception that the Third Circuit created, allowing a distribution in violation of the absolute priority rule (under a structured dismissal) without the (hypothetical) consent of the creditors. That exception would cause a flood of undesirable consequences. Indeed, an exception to a rule creates uncertainty, which in turn increases the number of litigations, which in turn reduces the chance of approval of a reorganization plan (W.M. LANDES en R.A. POSNER, "Legal Precedent: A Theoretical and Empirical Analysis", *J. Law & Econ.* 1976, 271). In that context, RUDZIK stated that *"Once the floodgates are opened, debtors and favored creditors can be expected to make every case that 'rare case'"* (F.F. RUDZIK, "A Priority Is a Priority – Except When It Isn't", *Am. Bankr. Ints. J.* 2015, 79). Therefore, one could use that "exception" to deviate from the legal protection granted to certain classes of creditors; that "exception" could alter the bargaining power of different classes of creditors (even in bankruptcies that do not end in structured dismissals); and the risk of collusion between different (classes of) creditors could increase considerably (the senior secured creditors and general unsecured creditors could team up to squeeze out priority unsecured creditors).

The judgement as a structural dam: legally and economically sound

It goes without saying that the judgement of the Supreme Court will work as a dam, successfully holding back the flood of problems described above. Moreover, the judgement is not only drafted in a legally coherent way, but is also economically correct. The Court, in her legal reasoning, *de facto* relies on a principle which, according to the creditors' bargain theory, lies at the foundation of reorganization proceedings: bankruptcy proceedings are not allowed to alter the pre-insolvency rights of the different (classes of) creditors, unless the creditors as a whole would

benefit from these alterations (D. G. BAIRD en T.H. JACKSON, “Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy”, *University of Chicago Law Review* 1984, (97) 100). The reason for that is simple. Only in that case can one assume that creditors would have agreed *ex-ante*on those amendments (T.H. JACKSON, “Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors’ Bargain”, *Yale Law Journal* 1982, (857) 860). The bankruptcy proceedings should therefore exclusively deal with maximizing the profits of the creditors as a whole and not with mere distribution issues. As indicated above, the distribution in the present case did *not* have a positive influence on the issue of profit maximization. Moreover, it was not even necessary nor possible to search for a potential hypothetical consensus, since the former truck drivers of Jevic had already objected to the outcome of the structured dismissal.

Although the judgment is economically justified, the classic coherent judicial outline of the judgement will ensure that even the non-believers and criticasters will have a hard time formulating a persuasive dissenting opinion on the case at hand.

One step further: the implications of the judgement for the practice of gifting

One might wonder what the implications of this judgement are for the practice of gifting, whereby a senior class of creditors diminishes his rights on the estate assets in favor of a junior class of creditors, to obtain approval of a Chapter 11 plan from that junior class of creditors.

At first glance, gifting faces the same problem as structured dismissals in the sense that it also seems to violate the absolute priority rule when there is an intermediate class of dissenting creditors, who has not been fully satisfied. Some judges believe that gifting is prohibited, since it is a violation of the absolute priority rule (*Re SPM Manufacturing Corp*., 984 F.2d 1305, 1st Cir. 1993), while others believe it is allowed (*Re Armstrong World Industries Inc.*, 432 F.3d 507, 3d Cir. 2005; *Re DBSD North America Inc*., 634 F.3d 79, 2nd Cir. 2011).

Unfortunately, the judgement of the Supreme Court refrains from commenting on the practice of gifting. In addition, the wording of the absolute priority rule leaves us in the dark as to the legality of gifting. A textual interpretation of the rule seems to predict that gifting is not allowed: a more junior class of creditors receives a distribution while a more senior class of creditors is not satisfied in full.

In our opinion, however, gifting should be allowed. After all, the absolute priority rule ensures that the dissenting class of creditors receives the share to which it is entitled pursuant to its rank, unless the dissenting class of creditors (hypothetically) agrees on a deviation from that rule. The fact that a senior class of creditors transfers a part of

its entitlement to the estate assets to a junior class of creditors, does not alter the fact that the dissenting intermediate class of creditors receives the share to which it is entitled pursuant to its rank (see also N.W.A. TOLLENAAR, *Het pre-insolventieakkoord*, Deventer, Kluwer, 2017, 170-172).

Recommendations for the European and Belgian legislator

Since the proposal for a directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU of 22 November 2016 also includes the absolute priority rule, we would like, in conclusion, to give three concrete tips to the European and Belgian policymaker.

Firstly, the American "reversed" absolute priority rule is absent from the proposal for a directive of the European Parliament and the Council. As discussed during the congress "Eyes on Insolvency 2017", this leads to undesirably results (see also N.W.A. TOLLENAAR, *Het pre-insolventieakkoord*, Deventer, Kluwer, 2017, 166-169). Secondly, the European and Belgian policymaker would do well to consider the uncertainties concerning the absolute priority rule which are present in other countries (as in this case) in the process of drafting the definitive directive and during the implementation of that directive. Clear wording plays an important part in this regard. Lastly, we would like to mention the unfortunate wording of the "absolute" priority rule. The priority rule is, as you can see, not absolute: one can deviate from it, at least by way of (hypothetical) consensus.

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